

5 February 2009

Domtar

Reuters: **UFS.N** Bloomberg: **UFS UN** Exchange: **NYS** Ticker: **UFS**

Domtar's 4Q in 300 words - Reducing price target

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Reducing Target from \$4 to \$2 and maintaining Hold

Reduction reflects a weaker earnings trajectory, based DB's reduced '09 estimate. While our \$2 target still offers substantial upside potential, we are not constructive on the stock, because of the cyclical headwinds the company is currently facing. Our Hold rating is based on a balancing of modest valuation against cyclical challenges.

4Q results were weak

Reporting GAAP EPS loss of \$(1.31) and pointing to loss of \$(0.04) net of special items (mostly impairment of goodwill and write-down of PP&E). DB was at \$0.05 and FC at \$0.06. Comps: 3Q08 = \$0.10, 4Q07 = \$0.06. EBITDA net of special items was \$132MM, suggesting that baseline EPS was more like \$(0.01) than \$(0.04).

Estimates and view

We are trimming our '09 estimate from \$0.05 to \$(0.20), with 1Q at \$(0.02). First Call was at \$0.03. However, the results were not without positives. Pension issues remain under control, and uncoated free sheet prices are apparently still holding steady. We do not expect paper prices to remain steady, but it would provide upside to our estimates if they do. Domtar now has high degrees of both operating and financial leverage, potentially making the equity an attractive option. Given current cyclical headwinds, we remain on the sideline for now.

Valuation/Risks

Our \$2 price target is based on a DCF valuation. We use a 8.0% weighted average cost of capital, based on a 11.4% equity cost of capital and a 6.0% after-tax cost of debt. Our nominal growth rate of 1.0% reflects annual declines of about 1.5% when adjusted for inflation. Upside risks a potential recovery in the economy, an easing in some input costs, and a weakening of the C\$ versus the US\$. Downside risks include a weaker economy, falling pulp prices, and higher input costs.

Forecasts and ratios

Year End Dec 31	2008A	2009E	2010E
1Q EPS	0.05	-0.02	-
2Q EPS	0.06	-0.05	-
3Q EPS	0.10	-0.05	-
4Q EPS	-0.04	-0.08	-
FY EPS (USD)	0.17	-0.20	-0.00
% Change	-33.7%	-523.7%	-
Revenue (USDm)	6,394.0	5,528.8	5,757.4

Source: Deutsche Bank estimates, company data

Deutsche Bank Securities Inc.

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Forecast change

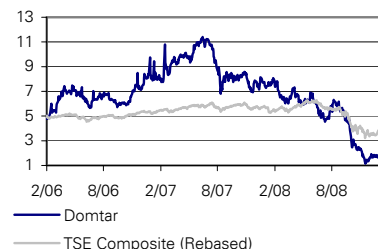
Hold

Price at 5 Feb 2009 (USD)	1.31
Price target	2.00
52-week range	7.81 - 1.14

Key changes

Price target	4.00 to 2.00	↓	-50.0%
EPS (USD)	0.05 to -0.20	↓	-523.7%
Revenue (USDm)	5,632.8 to 5,528.8	↓	-1.8%

Price/price relative

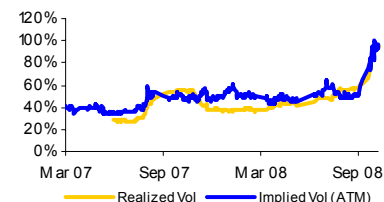


Performance (%)	1m	3m	12m
Absolute	-27.9	-44.1	-83.2
TSE Composite	-5.9	-14.1	-34.4

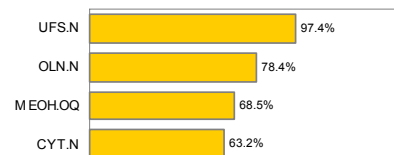
Stock & option liquidity data

Market Cap (USDm)	675.3
Shares outstanding (m)	515.5
Free float (%)	100
Volume (5 Feb 2009)	524,200
Option volume (und. shrs., 1M avg.)	5,287

Implied & Realized Volatility (3M)



Implied Volatility (3M, ATM) vs. Peers



*Weighted-avg. of index components
 Data as of 22-Oct-08

Model updated:05 February 2009

Running the numbers**North America****Canada****Paper & Forest Products****Domtar**

Reuters: UFS.N

Bloomberg: UFS CN

Hold

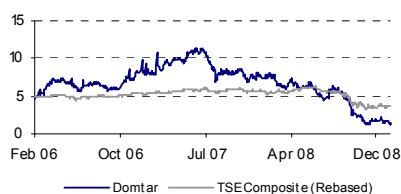
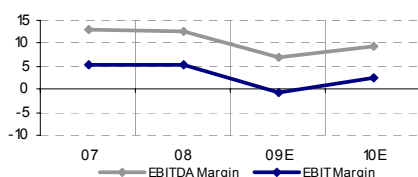
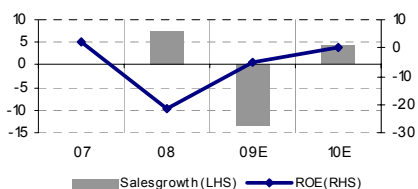
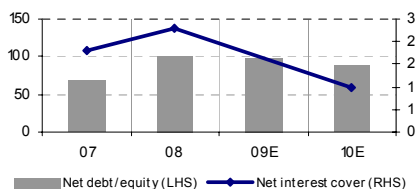
Price (5 Feb 09) USD 1.31

Target price USD 2.00

52-week Range USD 1.14 - 7.81

Market Cap (m) EURm 524
USDm 675**Company Profile**

With 2.3MM/mtons of uncoated free sheet capacity, Domtar is the third largest producer in North America. Domtar also produces coated free sheet and market pulp. Domtar is a 50% owner of Norampac a containerboard producer with 1.4MM tons of annual capacity. Finally, the company owns over 1.0MM acres of timberlands in the US & Canada and has lumber capacity of 1.2BBF.

Price Performance**Margin Trends****Growth & Profitability****Solvency****Mark Wilde**

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Fiscal year end 31-Dec

Financial Summary

	2007	2008	2009E	2010E
DB EPS (USD)	0.22	0.17	-0.20	0.00
Reported EPS (USD)	0.15	-1.11	-0.20	0.00
DPS (USD)	0.00	0.00	0.00	0.00
BVPS (USD)	6.74	4.16	3.96	3.95

Valuation Metrics

Price/Sales (x)	0.7	0.4	0.1	0.1
P/E (DB) (x)	40.5	30.4	nm	nm
P/E (Reported) (x)	60.7	nm	nm	nm
P/BV (x)	1.1	0.4	0.3	0.3
FCF yield (%)	12.3	2.6	23.4	31.8
Dividend yield (%)	0.0	0.0	0.0	0.0
EV/Sales	1.1	0.8	0.5	0.4
EV/EBITDA	8.3	6.1	7.2	4.6
EV/EBIT	20.7	14.5	nm	18.4

Income Statement (USDm)

Sales	5,947	6,394	5,529	5,757
EBITDA	782	795	373	537
EBIT	311	332	-39	134
Pre-tax profit	99	-570	-179	-3
Net income	70	-573	-104	-2

Cash Flow (USDm)

Cash flow from operations	606	197	308	390
Net Capex	-87	-128	-150	-175
Free cash flow	519	69	158	215
Equity raised/(bought back)	-1,431	0	0	0
Dividends paid	0	0	0	0
Net inc/(dec) in borrowings	518	-109	-79	-107
Other investing/financing cash flows	492	-15	0	0
Net cash flow	98	-55	79	107
Change in working capital	5	-226	0	-72

Balance Sheet (USDm)

Cash and cash equivalents	71	16	95	202
Property, plant & equipment	5,362	4,301	4,039	3,810
Goodwill	372	0	0	0
Other assets	1,943	1,787	1,787	1,807
Total assets	7,748	6,104	5,921	5,819
Debt	2,293	2,171	2,092	1,985
Other liabilities	2,258	1,790	1,790	1,797
Total liabilities	4,551	3,961	3,882	3,782
Total shareholders' equity	3,197	2,143	2,039	2,037
Net debt	2,222	2,155	1,997	1,782

Key Company Metrics

Sales growth (%)	nm	7.5	-13.5	4.1
DB EPS growth (%)	na	-22.8	na	98.1
Payout ratio (%)	0.0	nm	nm	nm
EBITDA Margin (%)	13.1	12.4	6.7	9.3
EBIT Margin (%)	5.2	5.2	-0.7	2.3
ROE (%)	2.2	-21.5	-5.0	-0.1
Net debt/equity (%)	69.5	100.6	97.9	87.5
Net interest cover (x)	1.8	2.3	nm	1.0

DuPont Analysis

EBIT margin (%)	5.2	5.2	-0.7	2.3
x Asset turnover (x)	0.8	0.9	0.9	1.0
x Financial cost ratio (x)	0.5	0.6	4.6	0.0
x Tax and other effects (x)	0.5	-3.1	0.6	0.6
= ROA (post tax) (%)	0.9	-8.3	-1.7	0.0
x Financial leverage (x)	2.4	2.6	2.9	2.9
= ROE (%)	2.2	-21.5	-5.0	-0.1
annual growth (%)	na	na	76.9	98.0
x NTA/share (avg) (x)	6.7	5.2	4.1	4.0
= Reported EPS	0.15	-1.11	-0.20	0.00
annual growth (%)	na	na	81.9	98.1

Source: Company data, Deutsche Bank estimates

4Q was weak. Reporting GAAP EPS loss of \$(1.31) and pointing to loss of \$(0.04) net of special items (mostly impairment of goodwill and write-down of PP&E). DB was at \$0.05 and FC at \$0.06. Comps: 3Q08 = \$0.10, 4Q07 = \$0.06.

Should EPS loss net of special items be \$(0.01) and not \$(0.04)? UFS is pointing to EBITDA net of special items of \$132MM. Depreciation was \$110MM, and interest expense was \$34MM (net of gain on debt repurchase). This suggests pre-tax loss of \$(12MM). Taxed down at a normal rate and divided by 516MM shares out, it looks to us like \$(0.01) in EPS. Tax treatment of special items makes exact calculation difficult.

The two big issues were very weak paper volumes and sharply lower pulp prices. These issues were partially mitigated by slightly lower input costs and a benefit from a weaker CN\$. The net result was a \$102MM q/q decline in Papers segment EBITDA. EBITDA in the Merchants and the Wood segments remained largely unchanged q/q.

Paper: While weak paper volumes were no surprise, the negative impact of the volume weakness was larger than expected. Transaction prices on pulp fell more than expected, due to orientation toward export markets. EBIT = \$29MM (excl'g special items), 3Q08 = \$131MM, 4Q07 = \$104MM.

Volumes: Paper volumes fell 15.1% (185K tons) y/y and 8.7% q/q. Pulp volumes fell 14.1% y/y (58K tons) but rose 8.6% q/q. Downtime and slowdowns amounted to 197K tons in Paper and 100K mtons in Pulp. Cost of lost volume was \$57MM (\$192/ton) [downtime and slowdown costs] plus \$38MM (\$128/ton) [other].

Prices: Uncoated free sheet prices were mostly stable q/q (flat in copy and down just \$3/ton in offset) better than suggested by industry newsletters. Domtar says that prices are still holding steady so far. Transaction prices in pulp, however, fell almost \$150/mton q/q, much worse than suggested by industry newsletters. About 60% of pulp volumes are exported, and pulp prices offshore fell more sharply than in North America.

Merchants: Still weak. EBIT = \$2MM, 3Q07 = \$1MM, 4Q07 = \$1MM. FY EBITDA of \$11MM provides EBITDA margins of barely more than 1%. On a q/q basis, lower volumes were offset by a decline in allowance for doubtful accounts.

Wood: Weaker C\$ and cost cuts offset lower volumes and prices. EBIT = \$(9MM), 3Q08 = \$(11MM), 4Q07 = \$(22MM). Still very weak, but understandable given volume and price environment.

Others: (1) Closing 293K tpy paper machine at Plymouth, NC in late February. Closures since March 2007 will amount to about 1MM tpy. (2) Guidance on modeling issues for '09: Capex = \$140-170MM, Depreciation = \$400-425MM, Interest Expense = \$130-150MM, Tax Rate = Low 40's. (3) Pension issues are better than expected. Plan assets declined 19%, but funded status improved y/y from \$(147MM) to \$(75MM) due to use of higher discount rate. Pension expense will actually decline slightly in '09.

Financial issues: (1) Liquidity is good, with just \$73MM drawn on \$750MM revolver. (2) Next major maturity is \$540MM in 2011. (3) Revolver matures in 2012. (4) Covenants include 4.5x Debt/EBITDA and 2.5x EBITDA/Interest. Based on our '09 estimates, 4.5x Debt/EBITDA may be breached by end of year.

Estimates? We are trimming our '09 estimate from \$0.05 to \$(0.20), with 1Q at \$(0.02). In 1Q, we are modeling some sequential EBITDA erosion. The main issues are lower forecasted prices in both uncoated free sheet and market pulp, partially offset by reduced downtime (due to closures), lower maintenance costs, and reduced drag from FX hedges.

We also assume further price erosion in 2Q. Our '10 estimate is \$0.00, based on a forecast of modest cyclical recovery.

Price target: We are trimming price target from \$4 to \$2. This reduction reflects our lower '09 estimate, as well as a higher cost of debt capital, based on tighter credit conditions. We maintain our Hold rating. While our new \$2 target still provides substantial upside from current levels, we are not inclined to become constructive given the cyclical headwinds and potential breach of financial covenants later in the year.

View: While this was a difficult quarter, two key positives also emerged: (1) Domtar says that UFS prices are still holding steady. We do not expect this to continue, but it would provide upside to our estimates if it does. (2) Pension issues are better than expected. Funded status actually improved y/y, and pension expense will remain roughly flat y/y. With over 4MM tons of pulp and paper volume on just over \$600MM of market cap, Domtar is a highly leveraged name. Assuming that a 10x multiple on free cash flow is "fair," the market expectation for free cash flow is \$60MM/year, or just \$15/ton. Swings much larger than \$15/ton are very possible in any given year, potentially making the Domtar equity an attractive option. Given current cyclical headwinds, we remain on the sideline for now.

Valuation

Our \$2 price target is based on a DCF valuation. We use a 8.0% weighted average cost of capital, based on a 11.4% equity cost of capital and a 6.0% after-tax cost of debt. The equity cost of capital is based on assumptions of 3.7% risk-free rate, a 7% market-risk premium, and a 1.1 beta. While the market-risk premium is high relative to historical averages, we believe that it's appropriate given current market turmoil. We believe the business is in modest secular decline. Therefore, our nominal growth rate of 1.0% reflects annual declines of about 1.5% when adjusted for inflation.

Risks

Upside risks for Domtar include a potential recovery in the economy, an easing in some input costs, and a weakening of the C\$ versus the US\$, since a weaker CN\$ will improve the competitive position of Domtar's Canadian operations. Other upside risks include better-than-expected volume and pricing. Besides the domestic and global macroeconomic risk, the greatest downside risk facing Domtar is potentially falling paper prices. Other key downside risks include exposure to various shifts in global exchange rates. While a strengthening in the US\$ benefits Domtar's Canadian operations, it could negatively impact offshore trade flows, negatively affecting prices. It would also likely put pressure on global pulp prices, which in turn could put pressure on uncoated free sheet prices. Other downside risks include higher energy, fiber, and freight costs, which could cause unit costs to rise.

Appendix 1

Important Disclosures

Additional information available upon request

Disclosure checklist

Company	Ticker	Recent price*	Disclosure
Domtar	UFS.N	1.32 (USD) 4 Feb 09	2,6,8,14,17

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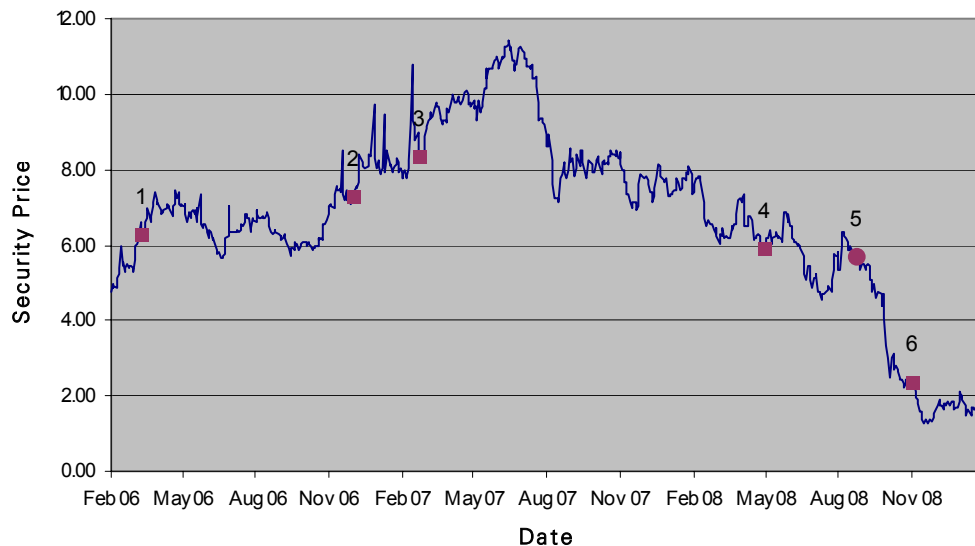
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Historical recommendations and target price: Domtar (UFS.N)

(as of 2/4/2009)



Previous Recommendations

- Strong Buy
- Buy
- Market Perform
- Underperform
- Not Rated
- Suspended Rating

Current Recommendations

- Buy
- Hold
- Sell
- Not Rated
- Suspended Rating

*New Recommendation Structure as of September 9, 2002

1. 3/17/2006:	Buy, Target Price Change USD9.00	4. 5/6/2008:	Buy, Target Price Change USD10.00
2. 12/6/2006:	Buy, Target Price Change USD9.50	5. 8/29/2008:	Downgrade to Hold, Target Price Change USD6.00
3. 2/28/2007:	Buy, Target Price Change USD14.00	6. 11/6/2008:	Hold, Target Price Change USD4.00

Equity rating key **Equity rating dispersion and banking relationships**

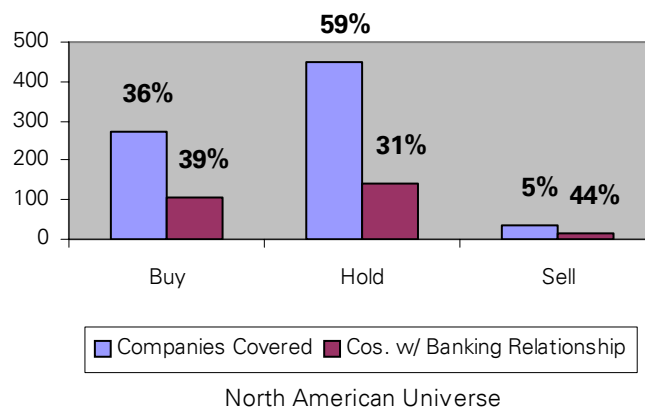
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